Global Mid Cap Growth Commentary

Q2 2021

Performance

SGA's Global Mid Cap Growth portfolio returned 6.6% (gross) and 6.4% (net) in Q2 versus 6.8% for the ACWI Mid Cap Index.

Highlights

- The rebound in cyclical stocks moderated in Q2 with growth outperforming at the end of the quarter; business quality metrics were rewarded marginally.
- The portfolio trailed its MSCI All Country World Mid Cap Index benchmark with stock selection detracting from relative returns and sector weights benefiting results.
- Stock selection in the Consumer Discretionary sector accounted for much of the underperformance due to significant weakness in TAL Education and New Oriental Education; selection in Information Technology and Consumer Staples also detracted, while selection in Health Care, Communication Services, and Financials benefited the results.
- A position in Mengniu Dairy was initiated during the quarter, replacing Kansas City Southern. Several other positions were trimmed on strength and others added to on weakness.
- The portfolio is positioned in our highest confidence long-term secular growth opportunities; the portfolio remained overweight Information Technology and Health Care sectors.

Global Recovery Facing Risks

Global equity markets rose sharply with investors betting on a broadening of the global economic recovery as vaccination programs advanced. This outlook, however, faced a growing headwind during the quarter as the more transmissible Delta variant of the COVID-19 virus spread quickly across the globe leading to new restrictions in many countries including India, Thailand, Japan, Australia, and Singapore. While optimism continued in Q2, investors also exercised a bit more caution given the variant threat, concerns over increasing inflationary pressures, rising tax rates and higher regulatory costs in the U.S. Investors may also be recognizing the largest fall off in fiscal stimulus since World War II and questioning whether this could derail or slow the global economic recovery. This caution led to a change in leadership in the markets with the appetite for cyclicals declining in favor of some higher growth businesses.

Key Change in China

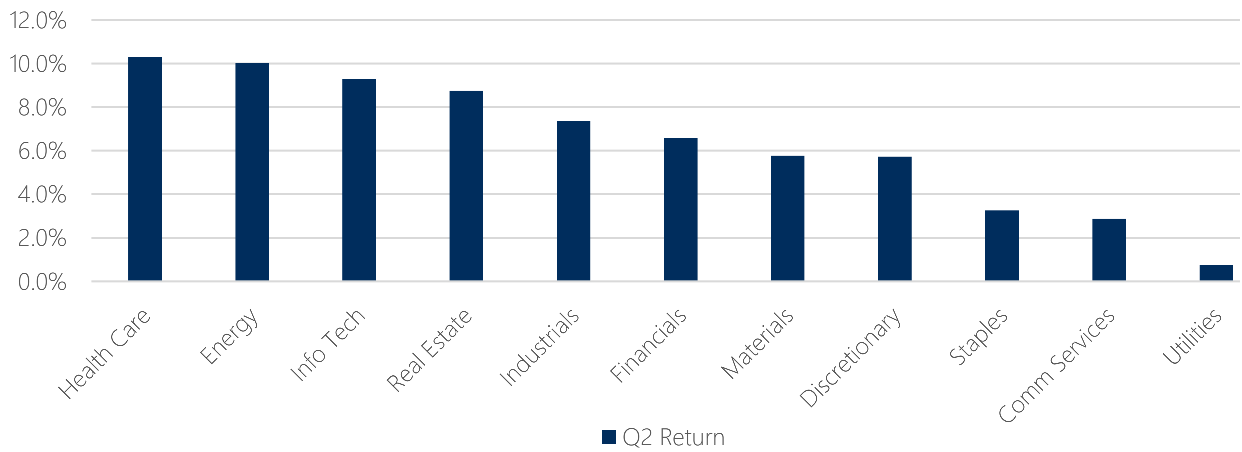
More news emerged on the trend toward greater Chinese regulation of industry, as China attempts to moderate the power of companies that have either become too dominant in the eyes of the Chinese regulators or are perceived as posing a threat to the Communist Party's image or agenda. Steps had already been taken by the government to weaken Alibaba and Ant Financial, and to restrict foreign capital from supporting excessive profiteering at the expense of local consumers and businesses. During the quarter, this more adversarial and ideological approach by the Chinese government severely impacted the private education industry, with new regulations pending which are expected to adversely affect the market opportunity in the area. The new willingness of the Chinese government to tightly control the operations of businesses and limit access to foreign capital is changing the investment landscape in China to a greater degree than anything seen since Premier Deng Xiaoping opened the country to entrepreneurship and foreign capital in the 1980s.

Today's more activist and adversarial approach to the regulation of China's enterprises, especially those listed overseas, and new access to foreign capital heightens the unique risks associated with investing in Chinese companies. Investors must now carefully assess whether businesses and their shareholder bases are viewed as central to advancing the Communist Party's agenda or represent a potential threat. As we research Chinese companies and evaluate their fit within our strategy, we will continue to focus on whether the predictability and sustainability of growth meets our criteria given the evolving risks.

Market Attribution

With greater focus on the impact of the Delta variant on economic recovery, developed markets broadly outperformed emerging markets despite strength in emerging Latin America and Europe. Brazil and Poland generated the best returns (+22.9% and +18.7% respectively) for the period while Chile, Egypt, and Peru performed the worst with returns of -14.2%, -9.2%, and -8.8% respectively. Asian markets in general were among the weakest performers with China returning only +2.3% as investor unease rose with greater government involvement, and Japan returning -0.3% as new COVID-19 cases emerged. In this environment, large caps outperformed small caps, and growth outperformed value. Business quality metrics were rewarded marginally with low debt, high ROE, and companies with earnings outperforming. Leadership in the market broadened during the quarter with the Health Care sector performing best followed by the Energy, Information Technology, Real Estate, and Industrials sectors. Utilities generated the weakest returns followed by Communication Services, Consumer Staples, and Consumer Discretionary.

MSCI ACWI Mid Cap – Sector Returns

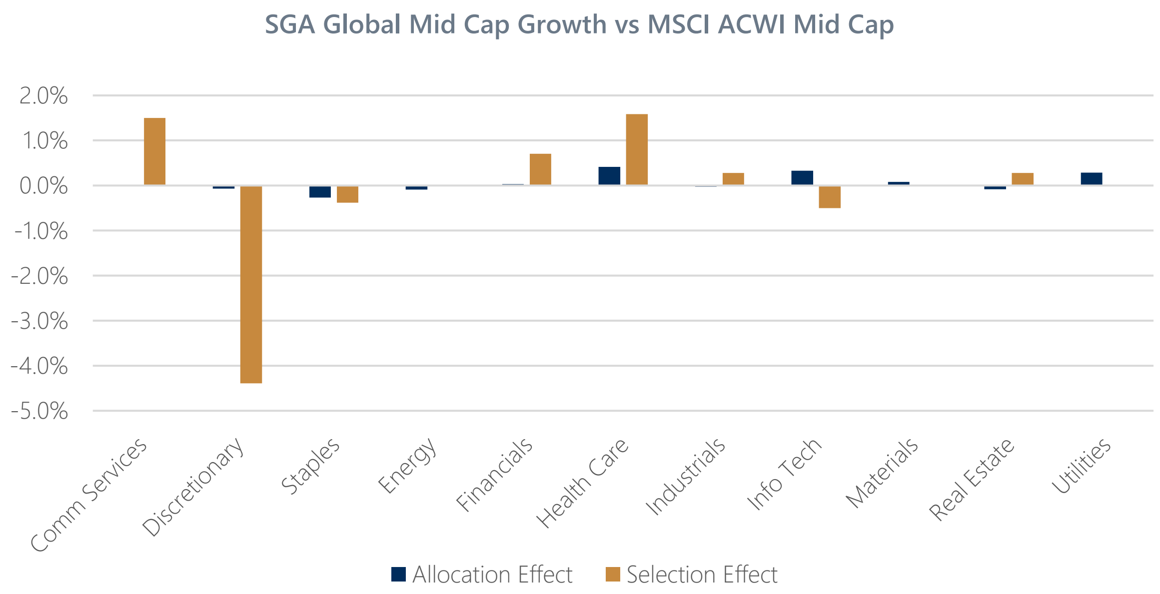


Source: MSCI

Portfolio Attribution

Stock selection detracted from portfolio returns during the quarter due primarily to selection in Consumer Discretionary where positions in TAL Education and New Oriental Education continued to weaken given ongoing concern over new regulatory steps by the Chinese government. Selection in the Information Technology and Consumer Staples sectors also detracted due to weakness in FleetCor, Workday, and CP All given the terrible impact of the Delta variant in Thailand during the period. Positive stock selection in Health Care, Communication Services, and Financials helped to partially offset the weakness given strong returns from WuXi Biologics, Kakao, and MSCI. Sector allocations contributed positively to relative returns with the portfolio's overweight in the strongly performing Health Care and Information Technology sectors and lack of exposure to the poorly performing Utilities sector having the largest impact. An overweight exposure to Consumer Staples detracted from results.

The portfolio's overweight in emerging markets relative to the index contributed to results during the quarter while selection in the U.S. and non-U.S. developed markets also contributed positively. Selection in emerging markets was the primary cause of underperformance relative to the benchmark. Relatively high vaccination rates in the U.S. and improving rates in Europe together with the expectation that economies in Europe would reopen soon benefited performance in those regions.



Source: FactSet, MSCI

Largest Contributors

Software product development and digital platform engineering provider **EPAM Systems** was the largest contributor to performance. With growth accelerating across industry verticals, EPAM delivered a strong quarter with revenue growth of +20% year-over-year (+8% quarter-over-quarter) and earnings +27% year-over-year. The company highlighted strong momentum in IT modernization projects and is winning over market share as clients consolidate vendors. Full year revenue guidance was raised to "at least 29%" growth. As demand for individualized software grows amid a shortage of quality engineers, EPAM is well-positioned to benefit from the trend toward building vs buying. Our research indicates that the company's swiftly growing IT Services segment provides a strong opportunity for EPAM's largely recurring revenues to continue to expand. We maintained EPAM at an above-average weight, trimming it back on strength.

South Korean super-app company **Kakao** was the second largest contributor to performance. Kakao's stock benefited from another strong quarter as the company delivered 45% and 80% year-over-year revenue and operating profit growth respectively in Q1. We continue to be impressed by Kakao's strong execution and innovation as the company has launched new features and services such as their digital wallet, talk channel, paid subscriptions, shopping, live streaming, and Kakao page in Southeast Asia, which all serve to make its platform more essential. With a dominant position in mobile messaging and online traffic given a growing user base of over 45 million we see exciting growth opportunities ahead as Kakao's platform remains under-monetized in areas of social commerce, paid content, and financial services. Given the stock's strong performance and valuation we trimmed the position, maintaining a below-average weight.

Chinese biologics technology platform **WuXi Biologics** was the third largest contributor to performance. WuXi's stock price rose as the company updated its 2021 revenue guidance during its recent investor day from 50% to 65% growth. Strong demand is driven primarily by COVID-19 vaccine and antibody-related projects, but the company is also seeing a recovery in its non-COVID related business. The longer-term growth opportunity for WuXi continues to be significant, driven by secular tailwinds in the biologics end-market and the outsourcing of drug development and manufacturing by pharmaceutical companies. We see WuXi as being well-positioned in this industry as the company now has 401 integrated projects, accounting for over one-third of global biologics projects. While R&D-related work accounts for a vast majority of WuXi's revenues today, in the coming years a greater share of revenues will be sourced from commercial manufacturing, which is more recurring and predictable in nature. We trimmed the position on strength given valuation, maintaining a below-average weight.

The fourth and fifth largest contributors to performance were **IQVIA** and **MSCI.**

Largest Detractors

The portfolio's two largest detractors for the quarter were after-school tutoring providers **TAL Education** and **New Oriental Education** even though both companies reported solid results for Q1. TAL's revenues increased 59% with ~~their~~ its online business growing an impressive 100%, while EDU's revenues and enrollment grew by 29% and 43% respectively, on a year-over-year basis. However, both TAL and EDU were negatively impacted by speculation over the content of new policies and regulations aimed at promoting educational quality and reducing the cost burden on parents of having more children given China's worrying demographic trends. Guidelines approved during the quarter by Chairman Xi call for reducing in-school burden, improving in-school teaching quality, extending school services post-teaching hours, and tightening regulation of after-school tutoring licensing, advertisement, operations, and cash management. Xi also focused on reducing the amount of capital chasing "excessive" profits and advertising that created anxiety for parents. Final regulations supporting these new guidelines have been pending for weeks, creating considerable speculation in the markets which has led to significant weakness in the stocks.

A belief that the Chinese leadership would approach the issue of education quality and regulation from a practical standpoint as opposed to an ideological standpoint was central to our thesis for both TAL and EDU and our rational for maintaining the positions during this period of speculation. We have conducted "man overboard" drills during the quarter aimed at evaluating and reconfirming our thesis for the businesses and believed that the government would prefer to see the private education industry heavily regulated to ensure that participants were providing a quality service at a fair price and had expected that the changes would still allow for attractive (albeit more moderate) growth. Further, our view was the demand for tutoring services would be resilient because it has been driven by China's college entry level testing system which was unlikely to change. S~~And s~~ignificantly curtailing the provision of tutoring services would only drive tutoring demand underground making it less subject to effective government regulation and potentially more expensive for parents.

Today we see a more extreme ideological approach is more likely and such a draconian view is reflected in the stock prices, which are trading significantly lower. While the valuation of the stocks appears quite attractive, the sustainability and predictability of both TAL and EDU's profit growth has become highly uncertain and we are reevaluating our theses.

Thai convenience retailer **CP All** was the third largest detractor from performance for the quarter as the company continued to be impacted by closures due to the effects from a second wave of the pandemic in Thailand. Strength at the company's Makro unit was more than offset by weakness at its 7-Eleven and Tesco/Lotus units. With uncertainty over the path of the COVID-19 flare up in Thailand, we lowered our same store sales and gross margin forecasts for the year but expect costs to also come in lower, offsetting some of the impact. While the near-term is less certain due to uncertainty over the pandemic and the pace of vaccinations, we continue to see an attractive growth opportunity for CP All in the post-pandemic world. As the Thai economy rebounds and begins to benefit again from renewed growth in the country's middle class and tourism over our 3-5 year investment horizon, the company's growth will resume. Despite the impact of COVID-19 in the second quarter, the country has not changed its plan to reopen for tourism and has recently been formulating plans for how to support it. We expect these moves to benefit the company as store traffic improves. We maintained an average weight position in the company during the quarter.

The fourth and fifth largest detractors from performance were **Trip.com** and **FleetCor**.

Portfolio Activity

Turnover during the quarter was below-average with a new position in Mengniu Dairy being initiated and the remainder of the portfolio's position in Kansas City Southern being liquidated. Positions in EPAM Systems, Kakao, and WuXi Biologics were trimmed on strength, while positions in New Oriental Education, TAL Education, RingCentral, FEMSA, and IQVIA were added to on weakness.

New Positions

Mengniu Dairy is a leading manufacturer and distributor of branded dairy products in China. Mengniu Dairy operates in a duopolistic industry-structure as it is one of just two brands with national scale and distribution capabilities. Dairy consumption in China remains well below that of developed markets, and it is among the lowest compared to other APAC countries and emerging markets. Dairy products play a vital role in a push for healthy diets and greater protein consumption by the Chinese government, and they are quickly becoming an important part of people's daily dietary habits. Rising dairy consumption in China presents a significant and long-duration growth opportunity, and Mengniu Dairy is well-positioned given its distribution, supply, and scale advantages along with a nationally recognized brand that is associated with high quality products.

The perishable nature of dairy makes inventory management and distribution capabilities a significant competitive advantage. Mengniu Dairy's entrenched distribution network and digitized systems provides the company with an advantage in terms of reaching customers and managing its inventory better than smaller competitors. With a growing market and rising demand, Mengniu Dairy's access to high-quality milk supplies is an additional advantage given broader supply constraints. Mengniu Dairy has spent years securing high-quality supplies and now controls several leading upstream suppliers. Its supply base, which is closer to the customer, allows the company to offer products that are fresher compared to competing products. As such, roughly 90% of its fresh milk is produced and put on the shelf in stores the same day. Customers' willingness to pay a premium for higher-quality products has allowed the company to price ~~their~~ its products higher than underlying inflation despite fluctuations in raw milk prices. Mengniu Dairy's pricing power is illustrated by the steady rise in gross margins despite raw milk price fluctuations. Price increases and mix shifts have contributed 4%+ annually of the company's topline growth over the past decade while volume growth is growing in the low double-digits. We see a highly attractive growth opportunity ahead for Mengniu Dairy given secular growth drivers combined with a unique position and sustainable competitive advantages.

Among the risks we are monitoring are the company's ability to effectively manage inventory during potential soft demand environments, supply chain management, and the risk of food safety incidents, which have been an issue in the industry historically. Food safety, however, is less of a concern today given enhanced monitoring upgrades across the entire value chain over the past decade and as Mengniu Dairy has adopted international quality assurance standards. The large carbon footprint of the dairy industry presents another key risk for Mengniu Dairy, however the company is actively addressing this risk by working with suppliers to reduce waste and emissions.

Sold Positions

The remainder of the portfolio's position in **Kansas City Southern** was liquidated after significant price appreciation caused its valuation to become less attractive following multiple acquisition offers.

Summary

The reopening rebound continued in Q2 with markets moving up sharply, but the nature of the rebound evolved with growth as a style regaining its leadership for the period, and investors' appetite for risk seeming to moderate with large-caps outperforming small-caps and quality metrics benefiting to a degree. While market trends became more beneficial for our approach during the period, the portfolio's holding in Chinese private education leaders TAL Education and New Oriental Education cost about -3.8% in relative return, more than offsetting any of the benefits from selection elsewhere. A broader, more adversarial and ideologically driven approach to regulation and foreign capital infusion became more apparent in China raising the risk associated with investment in the country. This heightened regulation will require investment opportunities to meet an even higher bar for predictability and sustainability of sales in addition to assessing their fit within the new ideological agenda of the Chinese Communist Party.

We continue to expect elevated volatility in equity markets as expectations surrounding the pace of vaccinations, the reopening of economies and new threats posed by COVID variants fluctuate. In addition, speculation regarding the transitory, or not, nature of inflation in the U.S., rising taxes and regulation in the U.S., and a myriad of geopolitical threats will continue to create more volatility in a market which has priced in high expectations. In this environment, our disciplined focus on predictable and sustainable growth businesses that we can access at attractive cash flow-based valuations should lead us to businesses that can continue to succeed regardless of the economic or regulatory backdrop. While relative results will vary from quarter-to-quarter, we remain confident that our time-tested approach and stable investment team will produce above average revenue and earnings growth which should lead to strong long-term absolute and relative returns over our 3-5 year investment horizon.

Global Mid Cap Growth Commentary

Thank you for your continued confidence in our team at SGA. We look forward to answering any questions you may have about the portfolio or our positioning.

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